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"Perspectives on the Health of the FHA Single-Family Insurance Fund"

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EXECUTIVE SUMMARY

I propose two measures to help the Federal Housing Administration (FHA) safeguard its Mutual Mortgage Insurance Fund (MMIF). The first measure involves filling a profound gap in the actuarial review. The second involves expanding access to underlying FHA data to research teams capable of enhancing the risk assessment.

1. <u>A GAP IN THE ACTUARIAL REVIEW</u>

The first measure involves filling a profound gap in the actuarial review. This gap makes it currently impossible to answer two basic questions.

1. What proportion of recent FHA-backed borrowers has defaulted?

2. What proportion is likely ultimately to default?

The centrality of these questions is evident. The answers determine the risks that FHA programs pose to taxpayers in their role as guarantors. They determine the probability that FHA-backed homebuyers will face the trauma of foreclosure. They determine the probability that Congress will be asked to recapitalize FHA's Insurance Fund. They determine the likely timing and size of any such request or requests.

Depressingly, the Actuarial Report does not answer these questions. Rather than projecting the success and failure of FHA-backed **borrowers**, it projects the performance of FHA-backed **mortgages**. This results in down-ward biased loss projections. Work that was initiated some two years ago with Joseph Tracy, Executive Vice President and Senior

Advisor to the President of the Federal Reserve Bank of New York, suggests this bias may be highly significant.[1] There is a far higher probability than currently projected that a large bill will be due taxpayers, that FHA-backed homebuyers will face foreclosure, and that Congress will be called upon to significantly recapitalize FHA's Insurance Fund. History will judge us poorly if we continue to bury our heads in the sand. Neglect is not benign, and time is most definitely not on our side.

While it may sound like a narrow technical issue, the distinction between projecting borrower performance and projecting mortgage performance is of highest practical significance. In recent years the FHA's "streamline refinance" program has been in high demand. In this program, FHA-backed mortgages can be refinanced to prevailing lower rates without any new underwriting. I regard this as an excellent program.[2] The problem is not with the program, but rather with the Actuarial Report, which treats each such refinance as if it represented final termination of FHA's insurance obligation. In truth, there is no cancellation of the underlying insurance and little by the way of additional fees to FHA. By lumping refinancing together with mortgage terminations in which the FHA's insurance obligation is extinguished, e.g. following a successful house sale, the Actuarial Report overestimates both FHA's past success rates and its projected future success rates.

My ongoing work with Joe Tracy suggests that the resulting underestimation of losses is significant. In this period of falling rates and housing market trauma, streamline refinancing appears to have been the most prevalent method of early mortgage prepayment. How could it be otherwise? There has been a significant incentive to refinance, as rates on standard FHA-backed mortgages have fallen from 6.00% p.a. in January 2009 to 5.23% p.a. in January 2010 and 4.51% p.a. in January 2011.[3] In the meantime, there has been little opportunity for turning a quick profit by selling a recently house and moving. If our preliminary findings on mortgage terminations hold up to further work on the underlying data, as we expect they will, default rates on recent FHA mortgages will stay at elevated levels for years after they are currently projected to decline.

I am upset with the slow pace of our progress on this research. Unfortunately reality is not on pause. My first proposal is for HUD to instruct IFE immediately to re-estimate the loss model linking together FHA mortgages that are refinanced one into the other.

2. DATA AVAILABILITY

My second proposal relates to data availability and analytic capabilities. I propose that Congress supply HUD with the additional resources it requires to make data available to

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[1] Aragon, Diego, Andrew Caplin, Sumit Chopra, John V. Leahy, Yann LeCun, Marco Scoffier, and Joseph Tracy, 2010, "Reassessing FHA Risk" NBER Working Paper No. 15802

[2] Just such a program was proposed in Caplin, Andrew, Charles Freeman, and Joseph Tracy, 1997. "Collateral Damage: Refinancing Constraints and Regional Recessions," Journal of Money, Credit, and Banking, vol. 29(4), 496-516.

[3] http://portal.hud.gov/hudportal/documents/huddoc?id=fharates_current.pdf

outside researchers and institutions with appropriate analytic capabilities, such as the Federal Reserve Bank of New York. Risk assessment will be dramatically enhanced once additional research teams are encouraged to participate. The resulting improvements will help FHA retain its reputation for helping homebuyers while safeguarding taxpayers.

The hour is late. Let us not fail in our collective responsibility to provide borrowers, taxpayers, and FHA itself with the information they require to effectively measure, mitigate, and manage true risk.